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MORTGAGE BULLETIN 1998-01

Subject: Mortgage Prepayment Penalty Restrictions

The Bureau has been presented with several queries regarding the possible preemption of Michigan's restrictions on mortgage prepayment fees and penalties. These queries have centered on two questions: 1) whether MCL 438.31c(2)(c) is preempted generally by Section 501(a)(1) of the Depository Institutions Deregulation and Monetary Control Act of 1980; and 2) whether Michigan's restrictions of mortgage prepayment fees and penalties have been specifically preempted where the loan is an "alternative mortgage transaction."

Bureau Position

- Section 501(a)(1) of the Depository Institutions Deregulation and Monetary Control Act of 1980 does not preempt MCL 438.31c(2)(c). As a result, lenders who make loans secured by first mortgages on residential property, except for certain alternative mortgage transactions, are prohibited from charging Michigan consumers prepayment fees or penalties outside of those allowed by MCL 438.31c(2)(c).

- The provisions of MCL 438.31c(2)(c) that limit the charging of prepayment fees and penalties are preempted by the Alternative Mortgage Parity Act of 1982, if the lender is a "housing creditor" and the extension of credit is made in compliance with the Alternative Mortgage Parity Act and other applicable regulations.

This bulletin outlines the limits of Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA") and the preemptive effect of the Alternative Mortgage Transaction Parity Act of 1982 ("Parity Act") on provisions of Michigan law that prohibit or limit the collection of loan prepayment fees or penalties.

I. Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980

Subsection (2)(c) of MCL 438.31c is Michigan's statutory limitation on the ability of lenders to restrict mortgage loan prepayments and provides, in pertinent part, that:

> "In connection with the transaction, except a loan, insured or guaranteed by the federal government or any agency of the federal government, if the security is a single family dwelling unit, the lender shall not do any of the following:
> . . . .
> (c) Charge a prepayment fee or penalty in excess of 1% of the amount of any prepayment made within 3 years of the date of the loan, or any prepayment fee or penalty at all thereafter, or prohibit prepayment at any time."

Section 501(a)(1) of DIDMCA expressly preempts State usury laws applicable to first mortgages on residential property: "The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance" that is secured by a first lien on residential real property. However, federal regulation 12 CFR 590.3(c) states that DIDMCA does not preempt "limitation in state laws on prepayment charges . . . or other provisions designed to protect borrowers."

The legislative history of DIDMCA's preemption provision clearly indicates the intent of Congress to preempt state limitations on charges included in the "annual percentage rate." The annual percentage rate reflects the amount of finance charge for the credit. The finance charge is the sum of charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit.

Prepayment charges are not interest on the loan itself, but ancillary fees or penalties. That is, they do not reflect the actual cost of credit, but incidental expenses that a lender may incur in handling a loan. Restrictions on the amount of those fees or penalties protect borrowers from being required to pay undue amounts in penalties or incidental expenses not related to the cost of credit. Clearly, such limitations on the charging of prepayment fees or penalties are not a part of the finance charge for the loan.

It is the Bureau's position that MCL 438.31c(2)(c) is not preempted by Section 501(a)(1) of DIDMCA. Accordingly, lenders who make loans secured by first mortgages on residential property, except for certain alternative mortgage transactions, are prohibited from charging Michigan consumers prepayment fees or penalties other than as allowed by MCL 438.31c(2)(c).

II. Alternative Mortgage Transaction Parity Act of 1982

Through the Parity Act, Congress intended to create an environment in which all "housing creditors," as that term is defined in 12 USC 3802(2), including state-licensed or chartered institutions, may make, purchase, and enforce "alternative mortgage transactions"

in conformity with applicable federal regulations. The term "alternative mortgage transaction" is defined at 12 USC 3802(1) as:

> ". . . a loan or credit sale secured by an interest in residential real property, a dwelling, all stock allocated to a dwelling unit in a residential cooperative housing corporation, or a residential manufactured home . . .[:] (A) in which the interest rate or finance charge may be adjusted or renegotiated; (B) involving a fixed-rate, but which implicitly permits rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule; or (C) involving any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions, including without limitation, transactions that involve the sharing of equity or appreciation; described and defined by applicable regulation . . ."

Thus, the Parity Act applies to all manner of mortgage instruments made by housing creditors that do not conform to the traditional fully amortized, fixed-rate, fixed-term, mortgage loan.

The preemption clause of the Parity Act provides that "[an] alternative mortgage transaction may be made by a housing creditor in accordance with this section, notwithstanding any State constitution, law, or regulation." To qualify as a "housing creditor," a person must comply with any applicable state licensure law. In making loans under the Parity Act, housing creditors must also comply with applicable federal regulations.[1] The applicability of particular federal regulations depends on the type of creditor making the loan: national and state-chartered banks must comply with applicable regulations of the Office of the Comptroller of the Currency ("OCC")[2]; state-chartered credit unions must comply with those of the National Credit Union Administration ("NCUA"); and all other housing creditors lending under the Act must comply with the regulations of the Office of Thrift Supervision ("OTS")[3] that govern alternative mortgage transactions.

The OCC has explicitly preempted state laws that block commercial banks from imposing prepayment fees or penalties in connection with alternative mortgage transactions. This regulation applies only to alternative mortgage transactions defined by the OCC as "adjustable rate mortgages," which are extensions ". . . of credit made to finance or refinance the purchase of, and secured by a lien on, a one-to-four family dwelling . . . where the lender... may adjust the rate of interest from time to time." Thus, the preemptive effect of this OCC regulation, as applicable to state-chartered banks, extends only to this specific type of alternative mortgage transaction (adjustable rate mortgages defined by 12 CFR 34.20), not all types of alternative mortgage transactions.

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1 It should be noted that in addition to those regulations identified by the appropriate federal agency as applicable to Parity Act lenders, other federal regulations of general application to mortgage loans must also be followed.

2 The applicable regulations of the OCC are 12 CFR 34.20 through 34.25.

3 The applicable regulations of the OTS are 12 CFR 560.33 through 560.35, 12 CFR 560.210, and 12 CFR 560.220.

Likewise, the OTS has authorized housing creditors other than commercial banks or credit unions to impose prepayment fees or penalties on alternative mortgage transaction borrowers. The OTS has adopted the Parity Act's definition of an "alternative mortgage transaction" without significant elaboration. However, the regulations do specify that, to be considered an alternative mortgage transaction the loan must conform to OTS regulations regarding late charges; prepayments; adjustments to the interest rate, payment, balance or term to maturity; and disclosures to the extent those regulations would apply if the same loan were originated by a federal thrift. Therefore, the preemptive effect of the OTS's prepayment fee and penalty regulations applies to residential real property loans made in compliance with applicable OTS regulations "in which the interest rate or finance charge may be adjusted or … a fixed rate [loan] … which implicitly permits rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization" (i.e. balloon mortgage) or any other type of loan "involving any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed term transactions …"

Applicable NCUA regulations do not allow prepayment fees or penalties to be charged by federal credit unions. Thus, State-chartered credit unions electing to lend under the Parity Act would encounter a general prohibition on charging prepayment fees or penalties.

The Parity Act authorized states to override the partial federal preemption of state laws applicable to alternative mortgage transactions within three years from the effective date of the Act, October 15, 1982. To do so, a state must have adopted, between October 15, 1982, and October 15, 1985, a provision which states explicitly and by its terms that such State does not want the preemption to apply with respect to alternative mortgage transactions.

Between October 15, 1982, and October 15, 1985, MCL 438.31c was amended on several occasions, however, none of these amendments expressed an intent to override federal law. Therefore, the restrictions imposed by MCL 438.31c(2)(c) on prepayment fees and penalties are subject to the Parity Act's preemption section.

Although the Parity Act preempts Michigan statutory restrictions on prepayment fees and penalties, where the mortgage is made in compliance with the Parity Act and applicable federal regulations, other federal law may nonetheless restrict, in certain circumstances, the ability of a Parity Act lender to charge borrowers a fee or penalty for loan prepayments.

The Truth in Lending Act ("TILA") prohibits lenders from charging borrowers prepayment fees and penalties on certain high fee or high interest mortgage loans (Section 32 loans). If the loan is of the type described in Section 103(aa) of the TILA, it may not contain terms under which a consumer must pay a prepayment fee or penalty for paying all or part of the principal before the date on which the principal is due. However, notwithstanding this

federal restriction on prepayment fees and penalties, if the mortgage referred to in Section 103(aa), at the time the mortgage was consummated, was made to a consumer whose total monthly debt payments did not exceed 50% of his or her gross monthly income and the income and debt payments are verified by the lender before extending the credit, the lender may charge a prepayment penalty if the terms of the prepayment fee or penalty meet other provisions of the TILA and Section 32 of Regulation Z, 12 CFR 226.32.

Regulations promulgated under Section 5 of the Home Owners' Loan Act of 1933, as amended by Section 341 of the Garn-St Germain Depository Institutions Act of 1982, provide that a lender shall not impose a prepayment fee or penalty when the prepayment is required pursuant to a due-on-sale clause of the mortgage or the note of indebtedness. This restriction on the lender's ability to charge a prepayment fee or penalty applies only where the lender is relying on the federal preemption of state law limiting due-on-sale clauses for the authority to enforce such clauses.

Under Michigan law where a lender demands a prepayment fee or penalty because a due-on-sale clause has accelerated the payment of a mortgage, no prepayment of the loan could occur because the full amount is now immediately due and payable by the terms of the due-on-sale clause. Therefore, "… [t]he lender loses its right to a [prepayment] premium when it elects to accelerate the debt … this is so because acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."[4]

Regulations promulgated under Section 501 of DIDMCA regarding residential mobile home loans[5] stipulate that borrowers may prepay in full or in part such loans at any time without penalty. However, these regulations only apply when the lender in making the loan relies upon the federal preemption regarding interest rate limits. If the lender relies on Michigan law for its interest rate in such mobile home loan transactions, the federal restriction on prepayment fees and penalties would not apply and the lender would then be subject to state law for any applicable limits on prepayment fees and penalties.

It is the Bureau's position that the provisions of MCL 438.31c(2)(c) that limit the charging of prepayment fees and penalties are preempted by the Parity Act, if: (1) the lender relying on the preemption is a "housing creditor"; and (2) the extension of credit is made in

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[4] Eyde Brothers Development Co. v. The Equitable Life Assurance Society of the United States, 697 F. Supp. 1431 (1988).

[5] The Parity Act covers loans made on "residential manufactured homes," which are defined as "… a structure, transportable in one or more sections, which, in the traveling mode, is eight body feet or more in width or forty body feet or more in length, or, when erected on site, is three hundred twenty or more square feet, and which is built on a permanent chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities, and includes the plumbing, heating, air-conditioning, and electrical systems contained therein …" See, 42 USC 5402(6).

compliance with the Parity Act and all applicable federal regulations. In other words, even if the lender is a "housing creditor" under 12 USC 3802(2), if the loan was not made in compliance with the provisions of the Parity Act and all applicable federal regulations[6], the prepayment fee and penalty restrictions of MCL 438.31c(2)(c) would not be preempted.

Further questions regarding this bulletin should be directed to the Examination Division of the Financial Institutions Bureau at (517) 373-3470.

/s/

Patrick M. McQueen, Commissioner

November 16, 1998
Date

/s/

Ann Gaultney, Director
Examination Division

November 16, 1998
Date

/s/

Barbara J. Strefling, Director
Licensing and Enforcement Division

November 16, 1998
Date

[6] This includes those regulation specifically identified by the appropriate federal agency as applicable to Parity Act loans as well as those federal regulations of general application to all mortgage lenders.

PREPAYMENT FEES AND PENALTIES: FEDERAL PREEMPTION OF MICHIGAN LAW

1. Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 **did not preempt** limitations in Michigan law regarding loan prepayment fees and penalties.

2. The Alternative Mortgage Transaction Parity Act of 1982 ("Parity Act") **did preempt** Michigan's limitations on loan prepayment fees and penalties for **certain** loans.

3. In order for a transaction to qualify for the Parity Act's preemption of state loan prepayment law a series of steps must be successfully completed.

First, the lender must qualify as a "housing creditor" under 12 USC 3802(2). This definition is broad and should encompass all state-regulated lenders who have complied with applicable state licensure law.

Second, the loan must be an "alternative mortgage transaction" as defined in 12 USC 3802(1) and applicable federal regulations. The applicable federal regulations are those provisions of the Code of Federal Regulations designated by the appropriate federal agency as being applicable to "alternative mortgage transactions."

The "appropriate federal agency" is determined by classifying the "housing creditor" into one of three categories (i.e., bank, credit union, or other regulated housing creditor).

If the creditor is a state chartered bank, it is subject to the regulations of the OCC identified as applicable to Parity Act loans

If the creditor is a state chartered credit union, it is subject to the regulations of the NCUA identified as applicable to Parity Act Loans.

Creditors other than banks and credit unions are subject to the OTS's Parity Act regulations.

Third, after the appropriate federal agency is determined the loan must be made in substantial compliance with all applicable federal regulations.

4. If the lender is not a "housing creditor" or the loan is not an "alternative mortgage transaction" or, even if the lender is a "housing creditor" and the loan is an "alternative mortgage transaction," the loan was not made in substantial compliance with all applicable federal law, Michigan's limitations on the charging of prepayment fees and penalties are not preempted – any prepayment fee or penalty associated with the loan must be within the limits of Michigan law.